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C O N F I D E N T I A L SECTION 01 OF 03 BRASILIA 002145

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TREASURY FOR DAS LEE AND F.PARODI

E.O. 12958: DECL: 08/11/2015

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SUBJECT: SECRETARY SNOW'S MEETINGS WITH FINANCE MINISTER  
PALOCCI AND CENTRAL BANK PRESIDENT MEIRELLES

Classified By: Charge d'Affaires Patrick Linehan, reason 1.4 (b)  
and (d)  
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[11.](#) (C) Summary: Secretary Snow met separately with Central Bank President Meirelles and Finance Minister Palocci August 1 in Brasilia for broad discussions of Brazil's current economic performance. Meirelles and Palocci both argued that Brazil's stellar economic performance, with a current account surplus of 1.9% of GDP anchored by booming exports and a strong fiscal stance (5.1% of GDP primary surplus), had insulated the economy from current political turbulence. Palocci implicitly acknowledged that the microeconomic reform agenda was stalled, but hoped that stronger growth in the second half of 2005 would allow the GoB to press forward with reforms, including a simplification of the tax system as applied to small and medium enterprises. Palocci placed significant emphasis on reenergizing trade negotiations as a tool to improve productivity in the economy (septel). Palocci said Brazil would like to join the OECD and sought support for Brazil's position on IMF quota reallocations. End Summary.

[12.](#) (U) Background: Treasury Secretary Snow visited Brazil July 31 to August 3, 2005, to participate in the fourth session of the bilateral Group for Growth, an outgrowth of the 2003 Summit between Presidents Bush and Lula. Secretary Snow held bilateral meetings August 1 in Brasilia with Central Bank President Henrique Meirelles (along with the majority of the Bank's Governing Board), Finance Minister Palocci and President Lula, in addition to meeting with Brazilian venture capitalists. In Rio de Janeiro on August 2, the Secretary participated in Group for Growth meetings (including a business breakfast), gave a speech sponsored by the Brazilian Council on Foreign Relations (CEBRI), and held a round-table discussion with representatives of the financial services sector. On August 3, in Vitoria, the capital of the Brazilian state of Espirito Santo, the Secretary emphasized the themes of private sector

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infrastructure investment and the importance of good governance in visits to the port of Tubarao and in a working lunch with Governor Hartung and local business. The Secretary concluded his stay in Vitoria with a visit to a

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favela (poor neighborhood) that benefited from an Inter-American Development Bank (IDB)-financed basic services project, aimed at providing running water, sewage hook-ups and paved streets. This cable reports on the Secretary's meetings with the Central Bank President Meirelles and Finance Minister Palocci. Septel reports on the trade aspects of Secretary Snow's discussions.

Economy, Interest Rates and Directed Credit

[13.](#) (SBU) Meirelles outlined Brazil's excellent economic performance over recent months and described its current policy stance. He argued that Brazil's pursuit of its three main macroeconomic policy pillars (fiscal adjustment, inflation targeting monetary policy and a flexible exchange rate) were producing outstanding results. While growth registered a small adjustment in the first quarter, he expected it would pick up in the remaining quarters, with the economy posting annual growth of about 3.4%. He added that the fiscal performance (5.1% of GDP primary surplus in the 12 months through June) had been solid and the external accounts outstanding (1.9% of GDP current account surplus in the 12 months through June).

[14.](#) (SBU) Meirelles declared that the Central Bank has been able to establish credibility with the market, despite its lack of formal legal autonomy. Still, he emphasized, the Bank's lack of formal independence meant that investors were

demanding a small inflation premium -- which would only disappear once formal autonomy was granted. Economic Policy director Bevilacqua added that inflation expectations for the year, after spiking in the first and second quarters, were nevertheless declining faster than expected in response to the current monetary policy adjustment.

15. (SBU) Meirelles noted that one of the reasons for Brazil's infamously high lending spreads is the country's system of directed credit. Although bank lending has been growing, he noted, only 34.5% of overall credit was freely allocated by banks -- the rest is directed primarily to low-cost agricultural credits or by the national development bank (BNDES). Meirelles argued that, while this system created credit market distortions, it reflected a set of widely-held societal priorities. However, he agreed with the Secretary's observation that this societal consensus might

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change over time. Meirelles further pointed out that these subsidized credits meant that the average lending rate was lower than the headline interest rates.

Vulnerability has Declined  
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16. (C) Citing similar factors, Palocci and Meirelles both argued (separately) that Brazil's vulnerability to shocks had decreased markedly. The GoB's debt burden was down (52% of GDP) and its external profile had improved. Dollar-linked domestic debt had fallen from 40% to less than 4% of total domestic debt while the GoB had increased substantially the amount of fixed interest rate debt. The current account surplus and the country's strong fiscal performance, they stated, were insulating the economy from the current political turbulence. Palocci affirmed that the return of GDP growth expected in the second half of the year may allow the GoB to retake the microeconomic reform agenda adding that he would like to see the economy open up faster. He stated that the GoB hopes to pass in the second half of 2005 legislation to simplify the tax system applicable to small and medium enterprises, and is now implementing the recently-enacted bankruptcy law. The goal is to maintain the strong fiscal stance and press forward with microeconomic reforms so as to create space for a monetary easing. The Secretary welcomed the focus on the microeconomic agenda,

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noting that the markets' benign reaction to date to the current political scandal was a tribute to the policies the GoB had pursued.

Palocci - OECD, IMF and Venture K  
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17. (C) Palocci stated that given its ongoing extensive cooperation with the Organization for Economic Cooperation and Development (OECD), Brazil would like to pursue membership in that organization. The GoB's goal is to forge with OECD interlocutors a common vision governing Brazil's accession process. The Secretary undertook to raise Brazil's request in Washington.

18. (C) Palocci thanked the Secretary for USG support of Brazil's position in the current review of IMF quotas. He asked for continued support as the process advanced.

19. (C) The Secretary briefed Palocci on his meeting with a group of local venture capitalists. Bringing together ideas and financing was a critical function of the financial system, the Secretary said, and it was encouraging to see this nascent sector in Brazil helping new companies get started. Palocci agreed, stating that he believes the sector, while new, has significant potential. He singled out the important contribution that venture capitalists make to the governance of small firms.

110. (U) This cable was cleared by Treasury.

LINEHAN